REPORT TO THE SECRETARY OF THE TREASURY
FROM THE

TREASURY BORROWING ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION

February 1, 2005

Dear Mr. Secretary:

Since the Committee's last meeting in November, the expansion has remained on track with real GDP in Q4 growing at an annualized pace of 3.1%. Q3 GDP growth has been revised higher to 4.0% from the originally reported 3.4%. During the second half of 2004, domestic demand rose at an exceptionally strong 4.6% pace. The latest economic readings point to a continuation of above trend growth in Q1, as a likely strengthening in exports offsets a slight moderation in domestic demand. The latest data also indicate that home sales are near record high levels and are likely to remain firm given mortgage applications for purchasing new homes.

Notwithstanding an expected January slowdown due to unseasonably cold weather, economic conditions seem supportive of another year of good economic performance in 2005. Consumer spending grew 4.6% in Q4, following an impressive 5.1% growth rate during Q3. Strong consumer spending is being fueled by a powerful secular trend of wealth creation. The trend is evident in not only the highest income quintile, where it has traditionally been focused, but also in the second and middle income quintiles. According to Federal Reserve Flow of Funds data, household wealth has nearly doubled over the last decade to over $46 trillion.

These positive outcomes are being reinforced by ongoing improvements in the labor market outlook and prospects for strong household income gains. The trend in payroll employment has remained solid, with job gains averaging over 200,000 per month in Q4. While this was softer than payroll growth in Q2, it does represent a pickup over Q3's moderate job growth. Payroll growth looks to remain strong in 2005. The 4-week moving average of jobless claims has remained fairly low and surveys of hiring intentions among firms are at recovery highs. While oil prices are below their October peak, they remain elevated. The impact of higher oil prices over the past year has moderated real output from what would have been spectacular levels to above trend growth.

Following core inflation's rise in the first half of 2004, its upward trajectory slowed in the second half of the year. The core CPI rose an annualized 2.3% in Q4, higher than the 1.5% annualized pace of Q3 but below the 3.0% annualized pace of Q2. The core PCE deflator increased at only a 1.6% annualized pace in Q4, holding the year-over-year change in

December to 1.6%, while the year-over-year change in the core CPI rose to 2.3%. Despite a renewed fall in airline fares, the decline in the value of the dollar and the pick-up in unit labor costs suggest a risk of increases in core inflation ahead. Similarly, a risk of future inflation is emerging in higher rates of utilization and the declining pool of available labor. The persistence of higher energy and other raw material prices may be prompting numerous industries to try to pass through higher costs in order to support earnings. The trade-weighted dollar has depreciated nearly 15% from its highs two years ago. The decline in the value of the dollar has resulted in a pick-up in import prices excluding food and energy. In particular, prices of imported consumer goods rose in 2004 for the first time since 1995. In addition, capital goods import prices were nearly unchanged in 2004 after being a drag on inflation for the prior 9 years.

After rising before the first FOMC tightening in June, long-term treasury yields have declined by roughly 50 basis points since this tightening cycle began. As the FOMC has since increased its short-term target by 125 basis points, this has led to a substantial flattening of the yield curve, even compared to previous tightening cycles of 1994 and 1999. However, the spread between long and short interest rates remains near mean historical levels in the 2- to 10-year portion of the curve. Over Q4, while the 10-year yields rose by 25bp, the 2s/10s curve has flattened by almost 25 basis points. Two-year yields are currently 170bp higher than the lows observed in mid-March and the yield curve is almost 70bp flatter than its steepest levels during Q4. The market is currently pricing in nearly a 100% probability that the Fed will raise rates by 25bp at the February FOMC meeting and is pricing in a funds rate of roughly 3% by mid-2005.

Fourth quarter reported earnings appear to be pointing toward signs of moderation in early 2005. After a strong acceleration over the past year and a half, and with half of the S&P 500 reporting, approximately two-thirds have exceeded expectations while 17% have failed to meet expectations. Slower growth of earnings in financials, specifically among insurance and brokerage concerns, and a moderation of earnings in software, old-line industrial and consumer discretionary sectors, are largely behind the slowdown in earnings growth. The peak in earnings growth for this cycle appears to be behind us. Equity markets have risen approximately 5% over the past three months ending January 28th.

The Federal budget performance on a twelve-month rolling basis was better than expected, mainly reflecting the effects of solid income and profit growth on tax receipts. However, ongoing military operations in the Middle East present upside risks to overall budget outlays. That said, cyclical forces suggest that the peak in the twelve-month rolling budget deficit has passed.

Against this economic and financial backdrop, the members of the Committee responded to Treasury's charge. The charge was composed of four questions. In the initial section, Treasury asked the Committee to comment on its issuance pattern given the recent growth in its expected borrowing needs.

In general the Committee felt there was no need to change issuance patterns as sufficient flexibility exists within the current framework. One member noted that the average maturity of the debt has shortened and advised consideration of lengthening the issuance maturity profile. Others pointed out that Treasury has increased issuance of 3-, 5- and 10-year maturities as well as longer-dated TIPS to account for this, as it has reduced net borrowing in bills and the 2-year note. Another member pointed out that the average maturity of issuance was shorter than the average maturity of debt outstanding and this would lead to a continued shortening of the maturity profile. Other members were more comfortable with this trend, but advised further consideration of this issue over time with portfolio optimization analytics and techniques. The Committee concluded that retaining a focus on new issuance of longer-duration instruments is appropriate and that further examination is warranted.

In the second part of the charge the Treasury asked to comment on the following topic:

While the stock of Treasury debt is well within historical and international norms as a percentage of GDP, questions have been raised about whether the large proportion of total debt held by foreigners creates risk for the Treasury. We would like the Committee's views on whether the high percentage of foreign ownership of Treasuries outstanding creates risks for future Treasury financing, broader risks to the U.S. economy or, instead, reflects the efficient use of Treasury securities as a financing and investment vehicle.

As a means of framing the discussion, one member presented the Committee with a presentation comprised of a series of charts and comments that summarized the degree of foreign participation in the Treasury market. These included portrayals of the stock of Treasury debt currently held by foreigners, just over 50%, a depiction of the split of this stock between private and official foreign sectors and a comparison of the amount of Treasuries held as a percentage of the gross foreign holding of fixed income assets, amongst others. The entire presentation is appended to the TBAC discussion charts.

The presenting Committee member concluded that the large portion of debt held by foreigners does not create a substantial risk for the Treasury. A broader, global investor base should be more stable than a narrow, concentrated, solely domestic one. Moreover, if foreign buying slowed or stopped, there is ample scope for domestic investors to fill the void given broad based observance of portfolio underweighting in fixed income portfolios. US market liquidity is deep and domestic holdings of Treasuries are at historic lows. For all of these reasons, the high proportion of foreign ownership of Treasuries should pose no risk to future financing. Similarly, high foreign ownership of US Treasuries - and of US financial assets in general -- should pose little risk to the economy. It is a reflection of the globalization of financial markets as well as the particular attraction of US assets, that foreign ownership of virtually all US financial assets has risen sharply. US financial markets are the most liquid by most measures. The majority of international transactions, revenues and contracts, are denominated in US dollars, and the dollar remains by far the largest reserve currency. It is true that the growth in foreign ownership of US assets is a reflection of the rise in the current account deficit. That said, financial market adjustments to this imbalance, which could include a lower dollar and higher interest rates, would represent a natural corrective process, and currently there is no reason to expect it to become destabilizing. The presenting member's conclusion was that the increase in foreign ownership of US assets reflects more efficient financial markets, and any efforts to reduce foreign ownership would be counterproductive.

Committee members in general agreed with the conclusions of the presenting member. Several members urged Treasury to continue to encourage the growth of foreign participation in financing markets. Members felt that with higher short rates would come greater risks of chronic or intractable fails if foreign participation in repo markets was not assured. Other members encouraged Treasury to examine stress scenarios which would be observed in the tails of the probable distribution of outcomes. Members also encouraged Treasury to consider extending the maturity of its newly issued debt to meet the strong external demand for its offerings. In general, most members felt that Treasury enjoys an enviable position with foreign investors, one which should be vigilantly maintained.

In the next section of the charge, the Committee considered the composition of marketable financing for the January-March quarter to refund $11.3 billion of privately held notes and bonds maturing on 2/15/05. The Committee recommended a $22 billion three-year note due 2/15/08, a $15 billion five-year note due 2/15/10 and a $14 billion 10-year note due 2/15/15. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in February and a $24 billion 2-year note issued in March, a $15 billion five-year note issued in March and a $9 billion reopening of the 10-year note in March. For the April-June quarter, the Committee recommended financing as contained in the attached tables. Relevant features include three $24 billion 2-year notes, a $22 billion 3-year note, three $15 billion 5-year notes, a $14 billion 10-year note in May followed by a $9 billion reopening of that 10-year in June. The Committee further recommended a $10 billion 10-year TIPS for issuance in April as well as a $9 billion re-opening of the same in June, and a $12 billion 5-year TIPS in April.

In the last section of the charge, Treasury asked the Committee to bring to its attention any other issues the group felt important with regard to the Treasury market. Members commented upon the need for market participants to comprehend in full the administration's upcoming proposal for Social Security reform. As financing requirements are likely to be impacted, a greater understanding of the proposal would allow market participants to better judge what, if any, impact those changes might bring in total debt outstanding and its composition.

Respectfully submitted,

Ian G. Banwell
Chairman

Thomas G. Maheras
Vice Chairman

Attachments (2)